

STOCK OPTIONS

What Are Employee Stock Options?

An employee stock option is the right or privilege granted by a corporation to an employee to purchase the corporation's stock at a specified price during a specified period.

Those stock option plans that meet the requirements of Sections 421 through 424 of the Internal Revenue Code (IRC) are referred to as *statutory* stock options; those that do not are referred to as *nonstatutory* (or nonqualified) stock options (NSO).

Statutory stock options consist of incentive stock options (ISO) and employee stock purchase plans (ESPP).

Determinations as to whether the specific provisions of an employer's stock option plan meet the requirements of the IRC will be made by the Internal Revenue Service (IRS).

In addition to these stock options, there is a California Qualified Stock Option, which meets the requirements of Revenue and Taxation Code (R&TC) Section 17502.

The following discussion further defines the various types of stock options and provides a detailed explanation of the California employment tax treatment of income derived from stock options. The attached one-page summary grid is provided for easy reference.

Incentive Stock Options

An incentive stock option must meet the specific requirements of IRC Section 422. The tax treatment of an ISO depends, in part, upon when the employee disposes of (i.e., sells, exchanges, gifts, or transfers) the stock acquired through the exercise of the option.

Stock which is disposed of after a required minimum holding period is said to have a "qualifying disposition." Stock not held for this period is said to have a "disqualifying disposition."

No income results from the grant or exercise of an ISO. Based on IRS Notice 2001-14, no wages result from the exercise of an ISO and income derived from the disposition of the stock acquired as a result of an ISO is not subject to California Personal Income Tax (PIT) withholding, regardless of whether the disposition is qualifying or disqualifying.

Income derived from the qualifying disposition of stock acquired as the result of an ISO is treated as a capital gain. In the event of a disqualifying disposition, the income is treated as compensation income which is not subject to withholding, but is reportable as PIT wages.

Employee Stock Purchase Plans (ESPP)

An ESPP, also referred to as purchase plan option, is a stock option intended for rank and file employees (whereas ISOs are usually intended for "key" employees).

ESPPs must meet the requirements of IRC Section 423; those plans that do not meet these requirements are treated as nonstatutory stock options (NSOs).

Employees exercising their options under an ESPP are required to retain the stock for a minimum holding period to have a "qualifying disposition." Stock sold pursuant to an ESPP that was not retained for the minimum period is said to have a "disqualifying disposition."

ESPPs may be granted with an option price below the full fair market value of the stock as of the date granted (this discount may not exceed 15%).

No income results from the grant or exercise of an ESPP. Based on IRS Notice 2001-14, no wages result from the exercise of an ESPP and income derived from the disposition of the stock acquired as a result of an ESPP is not subject to PIT withholding, regardless of whether the disposition is qualifying or disqualifying.

Income derived from the qualifying disposition of stock acquired as the result of an ESPP is treated as a capital gain. In the event of a disqualifying disposition, the income is treated as compensation income which is not subject to withholding, but is reportable as PIT wages.

Nonstatutory Stock Options (NSO)

An NSO is an employee stock option that does not meet the requirements of IRC Sections 421-424 and does not therefore enjoy a favorable tax treatment.

When an NSO is subject to tax depends upon whether or not, at the time the option is granted, the stock has a "readily ascertainable" fair market value. Whether an NSO has a readily ascertainable fair market value is

determined by IRC Section 83 and corresponding federal regulations. Most NSOs do not have a readily ascertainable fair market value at the time they are granted.

The income resulting from an NSO that is granted with a readily ascertainable fair market value is wages subject to Unemployment Insurance (UI), Employment Training Tax (ETT), State Disability Insurance (SDI), and PIT withholding at the time the option is granted and is reportable as PIT wages.

The spread income resulting from an NSO that does not have a readily ascertainable fair market value at the time it is granted is wages subject to UI, ETT, SDI, and PIT withholding at the time the option is exercised, and is reportable as PIT wages.

California Qualified Stock Option

Section 17502 of the R&TC provides that a stock option specifically designated as a California qualified stock option will receive the favorable tax treatment provided by IRC Section 421 if all of the following conditions are met:

1. The option is issued after January 1, 1997, and before January 1, 2002.
2. The earned income of the employee to whom the option is issued does not exceed \$40,000 in the tax year in which the option is issued.
3. The number of shares of stock granted in the option does not exceed 1,000 and the value of the shares does not exceed \$100,000.
4. The employee must be employed by the company at the time the option is granted or must have been employed within three months (one year if permanently disabled) of the date the option is granted.

If the provisions of R&TC Section 17502 are met, the option will be treated for California employment tax purposes as though it were a statutory stock option (see ISO for employment tax treatment).

If the provisions of R&TC Section 17502 are not met, the stock option is treated as an NSO.

Multistate Jurisdictional Issues

Stock options, as noted in the foregoing, may not immediately become “wages” subject to taxation. An employee may be granted an option in one state, exercise the option in a second state, and sell the stock in a third.

For UI, SDI, and ETT purposes, wages derived from the exercise of a stock option are subject to the jurisdiction of the state in which services are otherwise subject at the time the “wages” are *paid* (when the option becomes taxable).

For PIT purposes, wages derived from stock options are allocated between the states in which the employee performs services for the employer granting the option. This allocation begins when the option is granted and ends when the income derived becomes *taxable*.

Example: An employee is granted an NSO (without a readily ascertainable fair market value) for services performed in California employment. The employee retires and moves to Nevada, where he exercises his option. In this case, the spread income is subject to California for UI, ETT, SDI, and PIT withholding, and is reportable as PIT wages.

The wages are subject to California for UI, SDI, and ETT purposes because services were localized in California. Similarly, for PIT purposes, because all of the employee's services were performed in California, the income (and the tax thereon) is allocated exclusively to California.

Additional Information

California's employment tax treatment of stock options conforms to the federal employment tax treatment, which has evolved through court decisions and IRS rulings

Public Law 104-95, which precludes states from taxing the retirement income of non-residents, is not applicable to stock options.

CUIC Section 13028, which details withholding provisions applicable to pensions, annuities, and certain other deferred income, is not applicable to stock options.

Questions specific to stock options that are not addressed in this general information sheet should be directed to:

State of California
Employment Development Department
FACD Central Operations, MIC 94
10969 Trade Center Drive, Suite 203
Rancho Cordova, CA 95670-6140
(916) 464-2500

Attached is a matrix that provides a quick visual reference to the California employment tax treatment of stock options.

Equal Opportunity Employer/Program. Auxiliary services and assistance available to persons with disabilities.

Employment Tax Treatment of Stock Options

Federal Tax Treatment

California Tax Treatment

Type of Stock Option	Federal Withholding	FICA	FUTA	UI/ETT/SDI	PIT Wages Withholding	PIT Wages
Incentive Stock Option (ISO)						
Qualifying Disposition	Not subject ¹	Not subject ²	Not subject ²	Not subject	Not subject	Not reportable
Disqualifying Disposition	Not subject ²	Not subject ²	Not subject ²	Not subject	Not subject	Reportable when disposed
Employee Stock Purchase Plan (ESPP)						
Qualifying disposition	Not subject ^{1,3}	Not subject ²	Not subject ²	Not subject	Not subject	Not reportable
Disqualifying Disposition	Not subject ²	Not subject ²	Not subject ²	Not subject	Not subject	Reportable when disposed
Nonstatutory Stock Option (NSO)						
With Readily Ascertainable Fair Market Value When Granted	Subject when granted ^{4,5}	Subject when granted ^{4,5}	Subject when granted ^{4,5}	Subject when granted	Subject when granted	Reportable when granted
Without Readily Ascertainable Fair Market Value When Granted	Subject when exercised ⁶	Subject when exercised ⁶	Subject when exercised ⁶	Subject when exercised	Subject when exercised	Reportable when exercised
California Qualified Stock Option	N/A	N/A	N/A	Not subject	Not subject	Reportable only if disqualifying disposition

¹ IRC 421(a), FTR 14a.422A-1

² IRS Notice 2001-14, irrespective of *Sun Microsystems, Inc. v. Commissioner*, TC 1995-69 and IRS Acquiescence

³ IRS Private Letter Ruling (PLR) 9407013

⁴ IRC 83(a)

⁵ Rev. Ruling 67-257

⁶ IRC 83(e)(3), FTR 1.83-7-7(a)